

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Correa Analyst: Roger Lackey Bill Number: AB 339
Related Bills: See Legislative History Telephone: 845-3627 Introduced Date: 02-16-2001
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Net Operating Loss Conformity

SUMMARY

This bill would conform state law to federal tax law on net operating losses (NOL). However, this bill would not conform to the federal provisions allowing NOLs to be carried back.

PURPOSE OF THE BILL

The author's staff has indicated the intent of this bill is to allow state NOLs to be treated in the same manner as federal NOLs.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and be operative for taxable years beginning on or after January 1, 2001. This bill would apply in the computation of taxes only for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist the author in providing amendments to the implementation considerations identified below.

ANALYSIS

FEDERAL/STATE LAW

Simply stated NOLs are beneficial tax rules for losses that allow a taxpayer to deduct those losses against other years when the taxpayer realizes income

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

04/02/01

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses of a small business, and farming losses. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Existing state law conforms to the federal computation of an NOL. However, California does not allow NOL carrybacks. Depending on the type of taxpayer or amount of a taxpayer's income, the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies.

Existing state law provides for seven different types of NOLs:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	55% (2000 - 2001) 60% (2002 - 2003) 65% (2004 - on)	10 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%	10 Years
Eligible Small Business	100%	10 Years
Specified Disaster Loss	100% 50%	5 Years 10 Years
TTA, LAMBRA & EZ	100%	15 Years

Generally, for most taxpayers the computed NOL may be carried forward for 10 years as follows:

- For taxable years beginning on or after January 1, 2000, and before January 1, 2002, 55% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2002, and before January 1, 2004, 60% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2004, 65% of the NOL may be carried forward.

Special NOL treatment as stated in the above chart is provided for the following taxpayers:

- New businesses that are engaged in a trade or business activity that first commenced in California after January 1, 1994. "New business" special NOL treatment also applies to taxpayers engaged in certain biopharmaceutical activities for taxable years beginning on or after January 1, 1997, that have not received approval for any product from the U.S. Food and Drug Administration.
- Eligible small businesses that are engaged in a trade or business activity with gross receipts, less returns and allowances, of less than \$1 million during the taxable year.
- Taxpayers that suffer a casualty loss in an area declared a disaster area by the President or Governor and enacted into law may carry over 100% of an NOL for five years and 50% of any NOL remaining after the first five years for an additional 10 years.

- Taxpayers that operate a business in a Local Agency Military Base Recovery Area (LAMBRA), a Targeted Tax Area (TTA), or an Enterprise Zone (EZ). However, NOLs generated in these incentive areas may offset only income generated in the incentive areas, and the taxpayer may claim an NOL from only one incentive area in any year.

Special rules apply for taxpayers that have different types of NOLs generated in the same year. Generally, taxpayers operating in various tax incentive zones or within and outside tax incentive zones must allocate their overall loss between their various zone and non-zone activities. The deduction for such a taxpayer is limited to the NOL carryforward from one particular zone loss to the exclusion of all other losses or to a carryforward of the entire loss under the general NOL rules.

In the case of corporations doing business both within and outside of this state, California, as do most states, taxes corporations exclusively on a source basis. Source income is determined using an apportionment formula for business income and an allocation methodology for nonbusiness income. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned business income (or loss) and its allocated nonbusiness income (or loss).

In addition, **California law** allows special carryforward treatment for losses incurred as a result of a disaster declared by the President or Governor and enacted into law. That is, 100% of the excess disaster loss may be carried over for up to five taxable years. If any of the excess loss remains after the five-year period, 50% of the remaining excess loss may be carried over for up to 10 additional years.

THIS BILL

This bill would repeal all current special California NOL provisions (other than disaster losses and the rules relating to apportioning taxpayers).

This bill would conform the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL) to the federal NOL provisions. Specifically, this bill would allow taxpayers to carry forward 100% of the NOL to offset the income of the 20 taxable years following the taxable year of the loss. However, this bill would not allow the NOL to be carried back.

IMPLEMENTATION CONSIDERATIONS

It is unclear if this bill would allow carryovers of NOLs incurred prior to January 1, 2001, to be carried forward for 20 years as allowed by federal law or if NOLs incurred in taxable years beginning before January 1, 2001, would remain as provided by current California law.

LEGISLATIVE HISTORY

AB 91 (Zettel, 2001/2002) would conform state law to federal tax law on net operating losses (NOL), including allowing an NOL to be carried back, increasing the time period for carryforwards, and allowing 100% of an NOL to be claimed.

SB 1994 (Hurt, 1997/1998) would have conformed the state income tax law to federal law in regard to the treatment of NOLs. The bill was amended to prohibit carrybacks. The bill died in the Senate Appropriations Committee.

OTHER STATES' INFORMATION

Florida income tax law, applicable only to corporations, provides a 20-year carryover period but no carryback, and otherwise conforms to federal NOL rules.

Illinois income tax law conforms to federal law regarding NOLs.

Massachusetts income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the organization's existence.

Michigan income tax law conforms to federal NOL rules, including carrybacks for corporations. However, Michigan's personal income tax law does not allow carrybacks.

Minnesota personal income tax law conforms to federal NOL rules, while corporate taxpayers have no carrybacks and only a fifteen-year carryforward period.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Tax Revenue Estimate

Revenue losses under the Personal Income Tax Law and the Bank & Corporation Tax Law are estimated to be:

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 2000 Enactment Assumed After June 30, 2001 \$ Millions		
2001-02	2002-03	2003-04
-\$5	-\$40	-\$130

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Revenue losses under the Personal Income Tax Law and Bank & Corporation Tax Law would depend on the amount of additional net operating loss deductions that can be applied against taxable income.

The above estimates are based on prior year tax return data which indicate the total amount of operating losses and the amounts that were applied under current law to reduce tax liabilities. This data was then simulated to determine how much additional losses could be applied by conforming to federal net operating losses (carryforward provision only).

ARGUMENTS/POLICY CONCERNS

Tax incentive areas, including EZs, LAMBRAs, and the TTA, were primarily created to encourage development in economically disadvantaged areas. This bill would eliminate the more favorable NOL provisions for these areas and substitute rules that place all taxpayers on an equal footing with respect to the treatment of NOLs. Therefore, this bill eliminates one incentive for businesses to locate in these depressed areas.

If this bill is not amended to clarify the treatment of disaster losses, the NOL treatment for taxpayers who suffer a disaster loss under current law would be less favorable than the regular NOL treatment. The author may wish to consider amending or eliminating the special treatment under current law for disaster losses.

LEGISLATIVE STAFF CONTACT

Roger Lackey
Franchise Tax Board
845-3627

Brian Putler
Franchise Tax Board
845-6333